



ZACKS MARKET OUTLOOK AND STRATEGY COMMENTARY

Q2 2017

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July 26, 2017

Last quarter, I noted that market fundamentals were sound and investors would be wise to remain in equities to the extent investment objectives allow. That viewpoint has not changed. In Q2 2017, the S&P 500 rose +3.1% and global equities increased +3.38% (measured by the MSCI World). Strength was dispersed across all sectors except Energy (-6.4%) and Telecom (-7.0%). Notably, those sectors were among top performers in 2016, so we may be seeing some reversion to the mean in these cases.

But, this performance rotation may be symptomatic of the “Trump Bump” losing steam. Arguably, Energy and Financials were among the sectors that stood to benefit most from President Trump’s agenda of lower taxes and deregulation. From Election Day to the end of 2016, Financials rallied strongly (+16.8%) and Energy saw robust gains (+9.0%). But, since the turn of the year, Energy and Financials have been among the worst performers. Again, we may be seeing a reversion to the mean here, but I believe market participants are re-assessing the likelihood, extent and timing of economic reforms. With health care legislation in limbo, investors may be paring back expectations.

Last quarter, we expected corporate earnings to show convincing gains. We are seeing signs this will occur and be in-line with our expectations over the next quarter or two. Corporate America is healthy. Additionally, CEO’s don’t seem to mind that anticipated economic reforms may take longer, and be more watered down, than previously expected. Business confidence from CEOs of major corporations and small businesses is high and rising. The reason – the belief that regulations and taxes won’t get worse is an economic event in-and-of itself.

The global economy is supporting the growth story too with many Wall Street bulls pointing to the “global synchronous recovery.” In other words, positive earnings growth is expected across the board in 2017; this hasn’t happened since 2010. Instead of seeing pockets of strength and weakness in the global economy, 2017 is shaping up to be one big pocket of strength. Positive earnings growth is expected in the United States, the UK, the Euro area, Japan, and Emerging Markets. Stocks should continue to respond in kind.

This is Not 1999

One of the bigger stories this past quarter was the June pullback in the Technology sector. Mutterings of another “tech bubble” arose along with fears of high valuations. The concerns are not without merit. The NASDAQ Composite index closed above 6,000 for the first time in its 46-year history in late April, and kept moving higher in May.

But, this is not 1999. Not even close, in my view.

The Technology sector has shown consistent, solid earnings growth and the largest players have a tremendous surplus of cash with healthy free cash flow (FCF) yields. The average FCF for the biggest



Mitch Zacks
Senior Portfolio Manager

players in the space (Facebook, Amazon, Microsoft, Google, and Apple) is a healthy 5.6% as of the end of the quarter. That's better than the FCF yield on the S&P 500, which is a lesser 4.5%. This is not to say valuations are low – they aren't. Many technology companies are expensive and investors should be selective in choosing stocks within the sector. But, to suggest that this is 1999 all over again is an overstatement. Valuations are elevated, but this backdrop is vastly different than it was for technology companies in 1999, as you can see in the chart below.

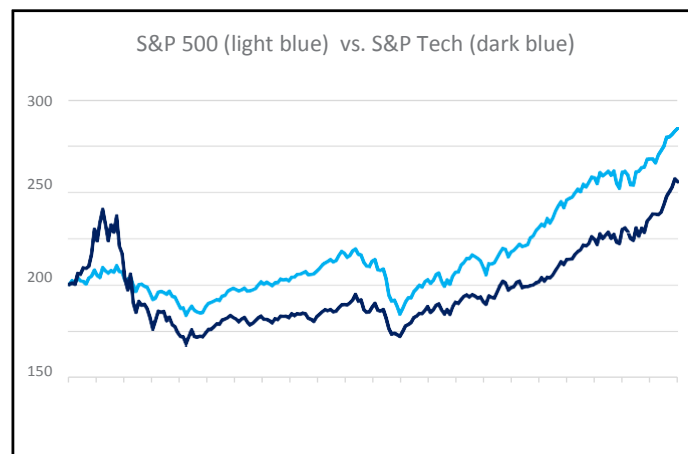
Tech P/Es are Somewhat Elevated but Nowhere Near Levels Seen During the Tech Bubble



Source: Bloomberg

Regardless, investors should remember that Technology is just one of ten sectors within the S&P 500. Diversification is 'king' when it comes to delivering long-term equity-like returns with controlled risk. Tech has been a solid contributor to total returns, but it's important to remember that the technology sector has not been as strong as the broader S&P 500 over the long-term—a point often overlooked.

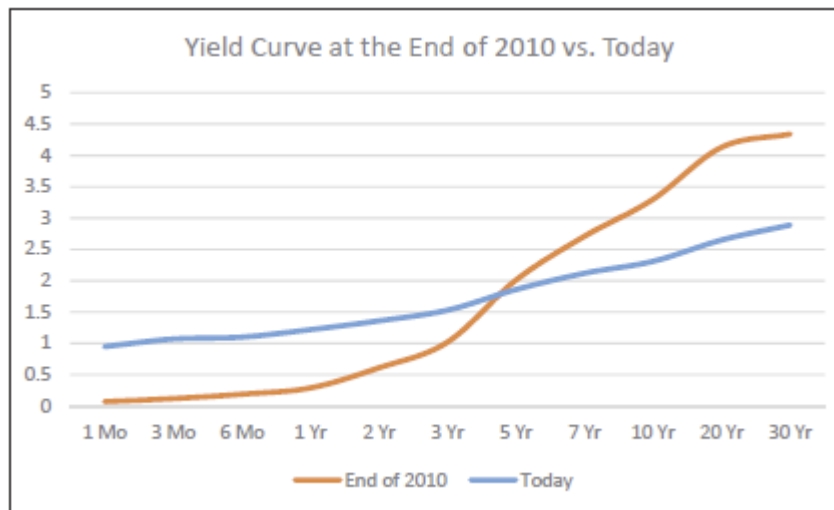
Tech Has Surged but Broad Diversification Has Delivered Stronger Returns over the Long-Term



Source: Bloomberg

Moving forward, watch the yield curve. For investors, stocks and bonds have been painting two different pictures of the economic outlook. On one hand, rising stock prices tend to reflect growth and expansion. On the other, a flattening yield curve tends to indicate a slowdown ahead. On average, the yield curve inverts 16 months prior to an economic recession and 13 months before major stock-market corrections. We're not at an inversion point yet. But, as you can see in the chart below, the blue line (today's yield curve) is notably flatter than the orange line (the yield curve at the end of 2010). If the yield curve starts to invert, that could be a major warning signal.

The Yield Curve is Flattening



Source: U.S. Department of the Treasury

I see this process taking time; at least twelve months, perhaps. But, indicators suggest the yield curve could flatten more. Economic conditions in the U.S. (with solid earnings growth, a tight labor market, and steady inflation) should support another Fed rate hike this year. This would put upward pressure on the short end of the yield curve. Conversely, modest inflation pressures, coupled with global demand for US Treasuries, should put downward pressure on the long end of the curve. We need to watch to see if the short end of the curve rises faster than the long end.

Bottom Line for Investors

As we expected, U.S. and global equities markets moved higher in 2017. I continue to believe the market will experience a correction, though when this will happen, or for how long, remains to be seen. Corrections are unpredictable and quick. Timing them is a feckless pursuit, in my view. The best thing to do is acknowledge corrections for what they are – and, stay cool. Even if the market declines 10+% later this year in a sharp and scary way, we still believe the fundamentals support the bull case over the next six to twelve months. Our recommendation to investors – stay the course.

All The Best,

Mitch Zacks

All Cap Core Strategy

Strategy Description: The Zacks All Cap Core Strategy relies upon a bottom up fundamental stock selection process coupled with our proprietary quantitative stock screening models. This strategy aims to provide risk-adjusted returns and diversification benefits relative to the broad market indexes.

Since inception, the Zacks All-Cap Core Strategy ranks in the top 7% out of 647 managers in the Morningstar All Domestic Equity Managers universe.

Both stock selection and sector allocation contributed positively to the All-Cap Core Strategy's performance, though stock selection mattered most as picks contributed across virtually every sector. For example, in the Energy sector, stock selection added 20 basis points to performance and sector allocation added 10 basis points. Energy-related industries ranked lower in the strategy's model and, as a result, the strategy was beneficially underweight to Energy by over 1% (relative to the Russell 3000). Stock selection in the strategy added value as it was heavily weighted toward integrated oil companies; in a declining oil price environment, integrated oil companies tend to outperform energy service and E&P (Exploration and Production) companies.

The data below illustrates this point. In a commodity downturn cycle, services and E&P companies see less demand. E&P companies also have high leverage, and thus their return on capital also tends to decline significantly. Integrated oil companies, however, are known for providing a stable dividend and have a large, long-term base of investors.

Performance by S&P 1500 Subindustries (12/31/2016 – 6/30/2017):

Integrated Oil Companies (S15IOIL Index):	-9.54%
Energy Services and Equipment (S15OILE Index):	-20.46%
Drillers (S15OILD Index):	-38.08%

Information Technology continues to produce alpha (excess return relative to its benchmark) for the All-Cap Core Strategy. Research indicates there is increasing demand for security software, semiconductors, cloud providers and electronic component and equipment makers. Some notable outperformers in this space were Universal Display (OLED) +26.88%, Nice Systems (NICE) +15.76%, and ProofPoint (PFPT) +16.8%.

The All-Cap Core Strategy also experienced strong performance from stock selection in Financials. The strategy avoided some segments that significantly underperformed the S&P 500. For example, the strategy did not include companies in the Thrift and Mortgage category (S15THMF Index), which fell by -4.69% over the quarter.

There has been significant year-to-date rotation within capitalizations, styles and sectors. A year ago, political forecasters predicted a Clinton win or an equity market correction with a Trump victory. Neither happened. In the wake of Trump's victory, U.S. stocks rose sharply and value stocks significantly

outperformed growth stocks, small-caps outperformed large-cap stocks, and cyclical sectors such as Energy and Financials outperformed defensive sectors. However, as we moved into 2017, most of those trends reversed:

	<u>6/16 - 12/16</u>	<u>1/17 - 6/17</u>
Small Cap (Russell 2000 Index)	18.66%	4.98%
Large Cap (Russell 1000 Index)	8.01%	9.27%

	<u>6/16 - 12/16</u>	<u>1/17 - 6/17</u>
Growth (Russell 3000 Index)	6.18%	13.69%
Value (Russell 3000 Index)	11.38%	4.32%

The point in highlighting this rotation is to reinforce the importance of managing investment risk while maintaining a balanced portfolio through the peaks and troughs of market cycles; the All-Cap Core Strategy, by design, serves this purpose.

Dividend Strategy

Strategy Description: The Zacks Dividend Strategy seeks tax efficient total returns from both capital appreciation and dividend payments. We focus on companies with attractive valuations, strong dividends and low risk characteristics.

Since inception, the Zacks Dividend Strategy ranks in the top 2% out of 821 managers in the Morningstar Large Cap Value universe.

The confluence of strong corporate profits globally, U.S. employment gains, and broad strengthening of global growth indicators supported positive market momentum. However, an offsetting factor in the U.S. was the lack of legislative progress. This arguably added to uncertainty regarding the administration's ability to advance an agenda of tax cuts and infrastructure spending. Additionally, the Federal Reserve's decision to raise interest rates in June, along with projections of tighter future monetary policy, created headwinds. The impact of further tightening on the economy remains to be seen, but chances are it could ripple into the earnings picture later this year if not next.

Still, one positive from the Fed was its recognition of strength in the banking system based on stress test results. The Fed's subsequent approval of banks' generous capital return plans drove a rally in bank stocks, in our view.

In the 'large value' space, Health Care and Financials outperformed over the quarter. Energy, Materials, and Technology underperformed, with energy prices weighed down by persistent oversupply in crude oil markets. The strategy's underweight to Energy and overweight to Health Care supported relative performance. Technology's pullback in June dragged on sector returns, and the strategy's overweight there hampered relative performance during the quarter.

If the administration can move forward with fiscal stimulus, and the Federal Reserve gradually tightens so that inflation remains in check, the U.S. and global economy should manage additional growth. It follows that global GDP growth for 2017 should support additional gains in the stock market. We believe the strategy is positioned accordingly to produce attractive returns.

Strategy Commentary

Finally, due to the tax-advantaged nature of the dividend payments, as well as the strategy's attractive yield of 3.14% (versus the 10-Year US Treasury's yield of 2.31% at the end of Q2), we believe it remains well-suited for investors seeking moderate growth and income

Focus Growth Strategy

Strategy Description: The Focus Growth Strategy seeks to own high quality growth stocks that have attractive fundamentals relative to their peer group. The Strategy focuses on large-cap growth stocks.

Despite underperformance to its benchmark, the Zacks Focus Growth Strategy continues to rank in the top 1% out of 954 managers in the Morningstar Large-Cap Growth universe since inception.

In June, the Federal Reserve raised interest rates for the second time this year (widely expected). However, the slightly dovish tone from Fed officials, coupled with strong earnings growth and positive global growth indicators, inspired investors to adopt a 'risk-on' approach that propelled stock prices broadly. For the year, the Technology and Health Care sectors have been among those leading the way.

The Focus Growth Strategy has been overweight to the Technology sector, which has benefited total return. Still, relative weightings to the Consumer Discretionary, Consumer Staples, Energy, and Financials sectors have hampered returns somewhat.

Though the global economy continues to grow, and earnings are expected to increase this year, we believe risks are rising at the margin and volatility is likely to increase. Nevertheless, we maintain a constructive view for U.S. economic growth as we enter the second half of the year. Also, we continue to favor firms with firm growth potential and prudent valuations.

International Strategy

Strategy Description: The Zacks International Strategy seeks diversification and growth through investments in both emerging market and developed nations. This strategy allows you to participate in economic globalization, in a risk controlled manner.

In April, the strategy was rebalanced with weight being increased to Austria, Italy, Spain, South Korea, Poland and Ireland. These calls supported performance as, for the three- month period ending June 30, Austria (EWO) returned +18.67%, Italy (EWI) was up +9.9%, Spain (EWP) +9.02%, South Korea (EWY) +9.6%, Poland (EPOL) +12.89%, and Ireland (EIRL) rose +9.55%. During the same period, the benchmark EAFE index rose by +6.37%.

Additionally, reducing weight to Australia (EWA), the UK (EWU), and removing Chile and Russia from the mix supported strategy performance as Australia (EWA) returned -2%, the UK rose a modest +4.69%, Russia fell by -7.26%, and Chile also fell by -2.76%.

To improve the strategy, we have added estimate revisions as a new factor to our country selection model. This new factor is in addition to others including: momentum of country equity index; export competitiveness via country exchange rate strength; volatility of country index; GDP growth estimates; financial integration and capital market maturity factors; and valuations factors as measured by common ratios such P/E, P/S, and Dividend Yield. After the model provides a quantitative rank, we use a set of quantitative tools, along with qualitative oversight, to set the final weight of each country.

The model and process is robust and the strategy has successfully navigated various geopolitical events and crises. One year ago, the world was grappling with the fallout of Brexit while Brazil was dealing with one of the worst political crises ever. Today, Turkey is still dealing with fallout from a coup attempt last year.

Developed markets, ex-US, have significantly underperformed U.S. equities over the last 10 years (see table). However, we see this trend reversing as valuations of developed markets, ex-US, are attractive and receiving significant earnings per share upgrades.

Total Return between 6/30/2007 – 6/30/2017

EAFE Index: +17.23%

SPX Index: +100.09%

Valuation	US	EAFE
Current P/B	3.09	1.70
Percentile (Historical)	73.10	39.0
Median (Historical P/B)	2.80	1.97

The recent outperformance serves as an important reminder that diversification and asset allocation for risk management are essential components for long-term growth. Zacks Investment Management has built its approach on succeeding in these areas. Many investors who significantly reduced international weightings in the last few years may have missed a significant part of this year's return from international markets. Our message is for investors to bring their international weight to the target suggested by our asset allocation model and in accordance with long-term goals and risk tolerance.

Mid-Cap Core Strategy

Strategy Description: The Zacks Mid-Cap Core Strategy seeks to outperform the Russell Midcap Index. The Strategy selects positions for inclusion based on a multi-factor analysis. The Strategy invests in both growth and value stocks and is optimized for the best risk-adjusted return potential.

Since inception, the Zacks Mid-Cap Core Strategy ranks in the top 2% out of 324 managers in the Morningstar Mid-Cap Blend universe.

Mid-cap stocks slightly underperformed large-caps, but outperformed small-caps, during the quarter. Total nonfarm payroll employment increased by 222,000 in June and the unemployment rate was little changed at 4.4%. Given the firm labor market, consistent economic growth and steady inflation, the Fed moved forward with a quarter percent interest rate hike in June. The Fed also signaled that further monetary policy tightening lies ahead this year. The impact of further tightening on the economy remains to be seen, but chances are it could ripple into the earnings picture later this year, if not next.

Lack of legislative progress has, arguably, led to increased uncertainty for fiscal stimulus in the form of tax cuts and infrastructure investments. This, in turn, has reduced expectations for future U.S. economic growth. This moderate growth environment tends to favor companies that can maintain and grow earnings, versus smaller companies whose fortunes are more leveraged to strong and/or accelerating economic growth. This could provide some competitive advantage for mid-cap companies relative to small caps looking ahead.

Strategy Commentary

Q2 2017 also saw the Federal Reserve recognize the strength of the banking system via stress tests. The Fed's subsequent approval of banks' generous capital return plans drove a rally in bank stocks toward the end of the quarter. As a result, overweight to the Financials sector supported the Mid-Cap Core Strategy's relative performance.

If the administration advances their economic agenda, then growth-sensitive mid-cap stocks could continue to experience strong gains. Mid-caps, in particular, could benefit from investors opting to deflect risks associated with small-caps (particularly this late in the business cycle), but who wish to pursue higher growth than might be seen in large-cap stocks.

Small-Cap Core Strategy

Strategy Description: The Zacks Small-Cap Core Strategy seeks to outperform the Russell 2000 Index. The Strategy selects positions for inclusion based on a multi-factor analysis. The Strategy invests in both growth and value stocks and is optimized for the best risk-adjusted return potential.

Since inception, the Zacks Small-Cap Core Strategy ranks in the top 7% out of 604 managers in the Morningstar Small-Blend universe.

U.S. stocks were broadly higher in Q2, but small-cap stocks underperformed large-caps and mid-caps. Job creation continued as total nonfarm payroll employment increased by 222,000 in June, and the unemployment rate was little changed at 4.4%. Given a firm labor market, consistent economic growth, and steady inflation, the Fed moved forward with a quarter percent interest rate hike in June. Additionally, the Fed signaled that further monetary policy tightening lies ahead this year. The impact of further tightening remains to be seen, but chances are it could affect the earnings picture later this year or next year.

The lack of legislative progress has, arguably, led to greater uncertainty regarding fiscal stimulus in the form of tax cuts and infrastructure investments; this, in turn, has lowered expectations for future U.S. economic growth. The current moderate growth environment tends to favor companies that maintain and grow earnings, as opposed to smaller companies that tend to perform better in a strong and/or accelerating U.S. economy. This outcome is not assured, however, as the administration could prove better at advancing legislation in areas where Republicans tend to agree more (such as economic reforms); this could feasibly accelerate economic growth enabling small-cap companies to thrive.

The inability, so far, to repeal and replace the Affordable Care Act means large-scale regulation of drug prices is not likely to occur in the near future. This benefits biotechnology stocks in the small-cap space, which emerged as the best performers during the quarter. The strategy's underweight to these stocks did hamper relative performance somewhat. Still, the strategy's overweight to the better performing Technology and Consumer Discretionary sectors supported relative performance. If domestic fiscal policies are implemented in a manner conducive to U.S. economic growth acceleration, then growth-sensitive small-cap stocks could continue experiencing strong gains.

DISCLOSURE Past performance is no guarantee of future results.

Results for the Zacks Strategies ("Strategies") reflect the reinvestment of dividends and other earnings. The results portrayed are the performance history of a single representative managed separate account that ZIM believes is representative of client accounts invested in the Strategy. A representative account must meet the following ZIM criteria to be selected: 1) there are no restrictions placed on the account, 2) ZIM has discretionary authority over the account, 3) the account has no capital additions and withdrawals and 4) dividends are reinvested. If the single representative account in use no longer meets ZIM selection criteria, ZIM will replace the representative account with another that meets the above ZIM selection criteria.

Prospective clients and clients should not assume identical performance results to those shown would have been achieved for their account if it was invested in the Strategies during the period. Clients of the firm may receive different performance than the representative account. Client performance may differ due to factors such as timing of investment(s), timing of withdrawal(s), and client-mandated investment restrictions. Wholesale, retail and institutional clients of the firm may have differing performance due to timing of trades.

Investments in the Strategies are not deposits of any bank, are not guaranteed by any bank, are not insured by FDIC or any other agency, and involve investment risks, including possible loss of the principal amount invested. Lower fees may apply to larger accounts; higher fees may apply to smaller accounts. Separately managed account minimums apply. Inherent in any investment is the potential for loss. Standard management fees are available on request and are described in Part 2A of Form ADV.

Indexes Presented:

The S&P 500 Index is a well-known, unmanaged index of the prices of 500 large company common stocks, mainly blue-chip stocks, selected by Standard & Poor's. The S&P 500 Index assumes reinvestment of dividends but does not reflect advisory fees or other expenses. An investor cannot invest directly in this Index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 1000 Growth Index is a well-known, unmanaged index of the prices of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 1000 Value Index is a well-known, unmanaged index of the price of 1000 large-company growth common stocks selected by Russell. The Russell 1000 Growth Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot directly invest in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The Russell 3000 Index is a well-known, unmanaged index of the prices of 3000 broad U.S. equity company common stocks, selected by Russell. The Russell 3000 Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

The MSCI EAFE is an index from Morgan Stanley Capital International. The MSCI EAFE is a well-known, unmanaged index representing developed nation countries around the world. The MSCI EAFE Index assumes reinvestment of dividends but does not reflect advisory fees. An investor cannot invest directly in an index. The volatility of the benchmark may be materially different from the individual performance obtained by a specific investor.

Zacks Investment Management may utilize mutual funds in some client portfolios. Zacks Investment Management is the advisor to these funds and will receive compensation from the funds and their shareholders for advisory services. Additional information is available upon request.

Morningstar Rank:

The Morningstar Universes used for comparative analysis are constructed by Morningstar (median performance) and data is provided to Zacks by Zephyr Style Advisor. The percentile ranking for each Zacks Strategy is based on the gross comparison for Zacks Strategies vs. the indicated universe rounded up to the nearest whole percentile as of 06/30/17. Other managers included in universe by Morningstar may exhibit style drift when compared to Zacks Investment Management portfolio. Neither Zacks Investment Management nor Zacks Investment Research has any affiliation with Morningstar. Neither Zacks Investment Management nor Zacks Investment Research had any influence of the process Morningstar used to determine this ranking.



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